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## INVESTMENT SECURITIES.—II.

BY FINANCIER.

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THE earnings of railroad corporations are subject to less variation, are less affected by the changing business conditions than the earnings of any other line of industry. The relative stability of the railroad receipts even in periods of industrial depression, as explained in the first article on this subject, is due to the economic necessity of railroad transportation.

In many lines of industry great fluctuations are experienced between the earnings of years of prosperity and those of years of adversity. The earnings of those industries, the products of which are in the nature of necessities, show the greatest stability. The more essential the output, the less is the variation from year to year in the earnings. Obviously, the obligations of a corporation, the earnings of which may be reasonably expected to reflect the varying conditions of business, cannot be regarded as constituting conservative investments. This explains, in part, why the so-called "Industrial Bonds"—that is, the bonds of industrial corporations—do not rank as high as do the securities of railroad and public-service corporations.

*Comparison of Earnings of a Railroad and an Industrial Corporation.*—A consideration of the earnings of some of the great industrial corporations for the years 1903 and 1904 will prove instructive in this connection. It will be remembered that during the year 1904 the United States experienced something of a business reaction. It was not severe, and at no time did conditions approach an industrial panic. Yet there was a marked decline in activity in certain lines of industry. The steel companies experienced a decided falling off in business. The statements of earnings of the United States Steel Corporation

shows the following results for the two years ended December 31:

	1903	1904
Gross Sales and Earnings.....	\$536,572,871	\$444,405,431
Mfg. costs, repairs, etc., charges of subsidiary companies.....	427,401,718	371,228,909
Net Earnings.....	\$109,171,153	\$73,176,522

In a year of very moderate reaction in general trade conditions, the gross earnings of the company declined 17 per cent. and the net earnings showed a decrease of 33 per cent.

Contrast with the reports of the United States Steel Corporation, the statements of the Lake Shore and Michigan Southern Railway for the same period:

	1903	1904
Total Gross Earnings.....	\$34,768,081	\$35,161,053
Operating Expenses.....	26,750,995	27,184,280
Net Earnings.....	\$8,017,086	\$7,976,773

The Lake Shore showed an actual increase in gross earnings in 1904 over 1903; but, as the increase in operating expenses was relatively greater, there was a decrease in net earnings amounting to \$40,313, or about one-half of one per cent.

Very few of the standard railroad companies suffered, in 1904, any substantial reduction in business from the volume of 1903. It is true that not many reported material increases, but they were in general able to maintain the records of 1903. The aggregate gross earnings of all roads in the United States, according to Poor's Manual, increased from \$1,908,858,000 to \$1,977,639,000. Net earnings in 1904 were \$639,240,000 against \$592,508,500 in 1903.

*Basis of Safety of Railroad Bonds.*—In the tendency of railroad earnings to remain constant, or to increase, is found the basis of the security and safety of railroad obligations. While railroad bonds as a class rank very high among investment securities, it does not follow that all railroad obligations are fully secured. A railroad, as well as any other corporation, may be bonded for an amount much greater than the assets and earning power of the company warrant.

The security of a railroad bond depends primarily upon (1) the form of the obligation and (2) the strength of the issuing

corporation. The companies enjoying the highest credit are the older, established roads, which serve well-developed, thickly populated sections of the country. The history of such corporations goes back through periods of adversity as well as of prosperity, and they have attained a position of such strength and stability that they may be relied upon safely to weather the storms which, from time to time, afflict the business world. Such corporations have long passed the experimental stage; their record for the past gives assurance for their future. Such roads, too, have little fear of new competition, because the more thickly populated a territory is, so much the more expensive and difficult is it to obtain, for a new road, rights-of-way, entrance into cities, terminals, etc. Among the roads of this character, the securities of which may be regarded as of the first rank, are the Pennsylvania; the Lake Shore and Michigan Southern; the New York, New Haven and Hartford; the Delaware, Lackawana and Western; and the Illinois Central. There are, of course, many others.

*Importance of Form of Obligation.*—Railroad bonds vary in security, not only with the strength of the issuing corporation, but also with the form of the obligation—that is to say, one railroad may have bonds outstanding of different merit. Ordinarily it may be said that those securities which lie “closest to the road” are the safest. The bonds, the security for which is the first claim on the earnings and assets of the corporation, naturally outrank those the claim of which is inferior.

*First-Mortgage Bonds.*—First-mortgage bonds have a first lien upon the earnings of a road, and, in case of trouble, upon the physical property of the road. The bonds are secured by a deed of trust under which the road is conveyed to a trustee, to be held in trust for the benefit of the bondholders. The road itself is pledged as security for the loan represented by the bonds. As long as the interest is paid promptly, the stockholders, being the owners of the road, are allowed to control and operate it. If there is default, however, either in the payments of the semi-annual interest charges or in the payments of the principal at maturity, the trustee may proceed to foreclose, to take possession of the road, to have a receiver appointed or take whatever action may be permitted by the court for the protection of the bondholders. The rights of the first-mortgage bondowners are superior to the rights of any other creditors of the road, except

possibly in those extraordinary cases where receiver's certificates have been issued. The peculiar status of receiver's certificates will be discussed later. If the road, for any cause, is taken away from the stockholders and operated by a receiver appointed by a court, the earnings, so far as applicable, must be applied to the payment of the first-mortgage bonds. If the road is sold at auction for the benefit of the creditors, the claims of the first-mortgage bondholders take precedence over the claims of any other creditors.

In case of default in the payment of the interest, providing the default last six months, or in the payment of the principal of the bonds at maturity, the lien by which they are secured is made effective by action on the part of the trustee. In our modern railroad mortgages or deeds of trust, a trust company is usually designated as trustee. The rights of the trustee are fully set forth, and it is important that sufficient power be given it to take whatever action may be necessary fully to protect the bondholders.

*The Deed of Trust or Mortgage.*—It is also important that, under the deed of trust, provision be made for compelling the trustee to act in case it is negligent in its duty. Holders of a majority of the outstanding bonds should be able conjunctively to compel action by the trustee. Provision should further be made for the removal of the trustee and the appointment of another should the interest of the bondholders require it.

Railroad bonds usually reach the investor through the medium of a private banking firm. It is the duty of the bankers, when they purchase an issue of bonds from a railroad with a view of retailing them to the public, to attend to the drawing of the mortgage or deed of trust, and to take proper care that all provisions are inserted which may be necessary to make the bonds as secure as possible. Our more important issuing bond houses and banking firms recognize their duty in this respect, and employ careful counsel to draw or approve the deeds of trust, securing the bonds which they may bring out. The investor, however, may well give attention to the form of the mortgage securing his bonds. While railroad mortgages are usually rather formidable documents to the layman, they may be analyzed with a little study, and any serious omissions or improper provisions may easily be discovered.

*Divisional, Branch-Mortgage Bonds, etc.*—Many of our railroads have different parts of their lines covered by different mortgages. Thus, there are Divisional First-Mortgage Bonds, Branch-Mortgage Bonds and Terminal-Mortgage Bonds secured, respectively, by a lien on a division, a branch line or a terminal. The security of such bonds depends upon the earning power of the particular part of the system by which they are secured. Terminal bonds are, in general, safe securities because terminals, by a lien on which they are secured, are most essential to the operation of the road. Perhaps there is no more important part of a road than its terminal properties, usually located in large cities where very heavy traffic originates or terminates.

While first-mortgage railroad bonds properly rank high as investment securities, they are safe only when the bonded debt charges are well within the earnings of the road, after the expenses of operation, maintenance, taxes, etc., have been deducted.

*Securities of Roads too Heavily Bonded.*—Some roads are bonded too heavily, and it is such as these which are forced into bankruptcy in periods of business depression.

There are roads which have first-mortgage bonds outstanding which are perfectly secure, but whose second and third mortgage and other debts are so heavy that default in some of the junior mortgages may be reasonably anticipated in the event of a business reaction. Such default will, undoubtedly, throw these roads into the hands of receivers. Even the first-mortgage bonds of a road the total debt of which is excessive are not fancied by careful investors, because, while the payment of the interest and principal may be assured, such bonds would not be easily marketable should the issuing road be forced into bankruptcy. There is little demand normally even for the fully secured bonds of a discredited corporation.

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